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Utilizing installment sales instead of 1031: Section 453 is a unique part of the tax code - by Michael Packman

November 17, 2020 - New York City

As I write this article, many are bracing for what may be major changes to the tax code that could add millions in additional liabilities for many. Real estate investors have taken advantage of section 1031 for many years to defer capital gains and is something that has been extremely beneficial to me. However, I was recently speaking with Mark Bianchi, the president of Titan Capital Recovery, who introduced me to another strategy that might be worth considering as well. This is a unique approach that uses section 453 of the tax code, instalment sales, as opposed to 1031.

An installment sale is a unique tax deferral strategy for any "highly appreciated asset" with a low basis. The strategy allows the seller to sell the asset and defer 100% of the capital gains tax for up to 30 years. Unlike 1031s, which are now limited to real estate, installment sales can be used for other assets such as art or an operating business.

The particular strategy that I have been evaluating is a monetization loan with an installment sale. The Internal Revenue Service permits capital assets to be sold without the immediate gain recognition via a monetization loan with an installment sale. Instead of the traditional installment sale structure, a seller can use the monetized installment sale (formerly known as a collateralized installment sale) strategy to defer taxable gain recognition.

Under a monetized installment sale, the seller agrees to sell the business or property to a dealer who resells the property to a final buyer using the original terms. Typically, the seller has already found the ultimate buyer and agreed upon terms, which the dealer follows. The seller takes back an installment contract from the dealer. The buyer pays the dealer in cash at closing, which is held in an escrow account.

The seller receives a limited-recourse loan from a third-party lender nearly equal to the sales price (usually 93.5%). This is a no-money-down, non-amortizing, interest-only loan. Sellers can then invest non-taxable loan proceeds as they see fit. Monthly interest payments on the installment contract will usually equal the seller’s loan interest payments. The final due dates on the installment contract and the monetization loan will typically be aligned, and the principal paid at the end equals or exceeds the outstanding principal balance the seller owes on the loan. When the installment contract ends the seller will recognize the gain from the installment sale.

This strategy can be applied to a wide variety of asset types and is a compelling alternative to more widely known deferral techniques, such as the 1031 tax deferred exchanges and deferred sales trusts. There are a few reasons why an installment sale may make sense. The most obvious reason is to avoid making a lump-sum capital gains payment to the IRS and state and local governments. For someone who is in the upper echelon tax brackets, this can easily be 30-35% of your sales proceeds.

Someone who sells a highly appreciated asset for $10 million in a high state tax state, with no basis can walk away with $9.35 million at closing instead of $6.5 million, an amount that can make a big difference when trying to find new investment opporttunities. While a 1031 exchange would allow you to differ the entire $10 million in this case, there are some rigid rules and regulations that you must adhere to, such as identifying a property within 45 days and closing in 180. When faced with uncertain environments as we are currently experiencing, it might be beneficial for some to sell a current holding and sit on the proceeds for a longer period of time. They would then have the ability to reinvest when they felt the time was right, as opposed to within the forced 1031 windows. Another potential advantage of the installment sale is that depreciation resets when the new property is purchased, unlike an exchange which might limit you to your current basis. For those who have owned a property for many years and have no or very little basis left to deduct, this can have a large impact on your after-tax cash flow on the new property. Mr. Bianchi cites the following example, "By utilizing an Installment Sale, an investor purchasing $10 million in real estate could potentially claim $2 million of depreciation upfront which yield as much as $740,000 in tax savings with another $2.2 million in tax savings over the 39 years."

As with any deferral strategy, the monetized installment sale strategy does not eliminate the capital gains tax, rather it defers the payment. At the end of the installment contract between the seller and the dealer, the capital gains tax will be due at the prevailing tax rate. While not a replacement for all potential 1031 exchanges, it may be an interesting strategy for certain holders of highly appreciated assets. As with any investment decision, always consult your attorney, CPA or other advisors before moving forward, but it is something I am looking at very closely myself, and others might find it worth exploring as well.

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